

Committee Secretary
Select Committee on the Reform of the Australian Federation
PO Box 6100
Parliament House
Canberra ACT 2600

SUBMISSION TO THE SELECT COMMITTEE ON THE REFORM OF THE AUSTRALIAN FEDERATION

I thank the Committee for holding this Inquiry and for allowing me the opportunity to contribute.

SUMMARY OF RECOMMENDATIONS

Political reforms to consider:

1. The Senate should consider establishing a permanent Senate Standing Committee on Federal Relations.
2. The Senate should consider establishing a system of liaisons between Senators and the Parliaments of their home States and Territories, to discuss matters of concern to both Parliaments.
3. The Senate and the State Legislative Councils (and the Queensland Legislative Assembly) should consider establishing a federal council of select upper house members, to discuss matters of concern to all upper houses in the federation.
4. The Senate should consider exploring avenues for taking over the conduct and management of COAG meetings, so that Executives of co-sovereign governments can meet on neutral ground and be subject to Senate questioning.

Fiscal reforms to consider:

5. The Commonwealth and the States should consider reducing Commonwealth income taxes and grants to the States, and enabling the States to levy a flat surtax on top of the Commonwealth income tax.
6. The States should consider implementing a broad-based property tax on unimproved land values, with a means-tested system for deferring payments if existing property owners cannot afford them, based on the HECS/HELP student-loan system. Ideally this would be accompanied by an abolition of both conveyancing stamp duty and Commonwealth capital gains tax on real property.

7. The Commonwealth Parliament could consider exercising the sunset clause in Section 96 of the Australian Constitution to retire, or modify, the power to make conditional grants to the States.
8. The Commonwealth could reserve the use of Section 96 conditional grants solely for States which receive Horizontal Fiscal Equalization transfers. States which do not require such transfers should at least be able to decide their own expenditure priorities, subject to the suffrage of their State voters.

INTRODUCTION: FEDERAL POWER SHARING

A federal system of government is a power sharing arrangement. It is natural for the more powerful partner in such an arrangement to view its co-sovereign partners chiefly as impediments to the implementation of its policies, and to entertain the idea of replacing those co-sovereign partners with inferior agencies such as “regional governments”. The fact that such a change might be desirable for the central government does not necessarily mean it would be desirable for the people of Australia. Otherwise, why not abolish the Senate too?

The Constitution of Australia is not perfect, though it is among the best in the world, and in all reasonableness it can hardly top the list of causes for the problems in Australian federalism. Any machine, if not adequately maintained, may suffer poor performance and breakdowns; the underlying problem may not be solved by trading in the mishandled machine for a different model.

Rumours of the obsolescence of federalism are much exaggerated. Internationally, a federal structure is increasingly being recognized and adopted as the most advanced form of democratic government, and Australia is seen as one of its finest exemplars. Even in the absence of marked cultural divisions between provinces or regions, federalism is an ingenious way of combining national unity for certain public functions which are naturally monopolistic, with the advantages of competition and diversity in the provision of other, less monopolistic or more localized public goods.

I believe there are two main problems with federalism in Australia. The first is the lack of dialog between State and Commonwealth Parliaments (as opposed to Executive governments which meet in COAG), and the second is vertical fiscal imbalance. A third problem, erosion of State government responsibility to State voters in the pursuit of conditional grants, only becomes a problem because of the vertical fiscal imbalance problem; without that, conditional grants could play a smaller but potentially very constructive part in the Australian federation.

Reform of federalism, and the generation of ideas for that reform, should therefore start not with the Constitution but with the Australian Senate, and I consider it a very hopeful sign that the Senate has begun this process by holding this Inquiry.

SENATE INVOLVEMENT IN STATE AFFAIRS

The States and Territories are collectively responsible for about two thirds of the government activity in Australia. The Commonwealth exercises control and supervision of approximately 30 per cent of the funding for these State activities, in the form of Specific Purpose Payments, and exercises varying degrees of influence over the remaining 70 per cent which comes from State own-source revenue and GST grants.

The coordination of these grants and related State activities is governed through a council of Executive Governments which is conducted outside Parliament, with no transparency to the Senate or the Australian public. The Council of Australian Governments (COAG) makes decisions of profound significance for the daily lives of Australians, and we don't know how it makes those decisions. What we do know is that the Commonwealth Executive holds all the cards because the States are dependent on it for money. COAG may be the most powerful instrument for Commonwealth Executive power ever devised in the Federal Commonwealth of Australia.

This should make federal issues a matter of ongoing concern to the Commonwealth Parliament; not just a subject of occasional meetings between Executive governments in a non-parliamentary arrangement.

The Senate of Australia was created to represent the people of the several States; not, as in pre-1913 America, to represent the State Parliaments. However, the fact remains that Senators and State Parliaments are elected to represent the same constituencies, and this should be enough reason for the Senate to take an active and ongoing interest in State concerns, just as much as the Cabinet does, if not more so.

This could take various forms, such as

- A permanent Senate Standing Committee on Federal Relations;
- A formal process for meetings between Senators and the Parliaments of their home States;
- A federal council of Senators and Members of Legislative Councils (and the Queensland Legislative Assembly) to meet periodically;
- The Senate to take charge of COAG meeting procedures, with Commonwealth and State ministers appearing as guests of the Senate and subject to Senate questioning.

Measures such as these might give Senators an alternate point of view to balance some of the anti-State sentiment that is common not only in and around Parliament House, but also around the country where many citizens have learned the habit of turning to the government that has the financial clout to solve all their problems. Solutions to issues in Australian federalism could arise in the course of these inter-Parliamentary dialogues, which may be more imaginative and more effective than anything I could suggest.

I will go on to suggest some further ideas for the reform of fiscal arrangements (again, without any need for referenda). However, I believe Senate-driven reform is the key. If intergovernmental relations are placed in a more democratic, transparent framework, I think the rest will follow in time.

VASSAL STATES

The second of the two main problems with Australian federalism is vertical fiscal imbalance. This is complicated by some of the arrangements for intergovernmental transfers to compensate for that imbalance. While some of these arrangements are superbly designed, an element of political arbitrariness does tend to creep in and compromise the whole federal model.

Commonwealth governments often take the view that it is up to them to ensure that State governments spend their money well. This implies that the Commonwealth retains ownership of the

funds it supplies to the States, and that State Parliaments and State voters are not capable of overseeing the responsible use of those funds. When intricately detailed conditions are attached to federal grants, State governments are compelled to devote more and more resources to lobbying for, and reporting against the conditions of those grants to the Commonwealth government. This undermines the relationship between a State government and its electorate.

Section 96 conditional grants are potentially useful, but they are overused, sometimes for politically opportunistic purposes, and this leads to a vicious circle of declining quality of government and increasing Commonwealth supervision. Whether this supervision, and the performance-based bonus approach recently adopted for National Partnership Payments, actually leads to better State government is debatable.

There is a danger of the Commonwealth's performance measures and priorities being inconsistent with those of State voters. Where the Commonwealth and the State electorate compete for the priorities of State government, the Commonwealth has the upper hand, because a State government have little hope of satisfying its voters if its budget is diminished.

LET VOTERS HOLD THE CARROT AND STICK

A more democratic way of influencing State government performance might be to publish benchmark comparisons in a format which the public can easily understand. Which States make it hardest to build a new home? In which cities do residents make the most use of public transport to get to work? If the Commonwealth government were to create a "My State" website providing answers and supporting data for hundreds of questions like this, there would be no need for intergovernmental performance bonus payments. Voters could make their own judgements based on the comparative information, according to their own democratic priorities.

STATE INCOME TAX OR SURTAX

It has been suggested that the Commonwealth could make room for the States to levy their own income taxes in addition to the Commonwealth income tax.

While this could address the problem of vertical fiscal imbalance, it could introduce new problems. Much of what the Commonwealth government does with revenue may be loosely described in the newspapers as "spending" but is more accurately described as transfers or redistribution. The income tax system is the centrepiece of the transfer system, and this makes it a natural monopoly for central government. The problem is explained by Robin Boadway and Anwar Shah in their comparative study of federal government practices, *Fiscal Federalism*.

The main argument for dominant federal involvement in the income tax concerns redistribution. The income tax is the main tax that is available for addressing equity objectives. Given the presumed interest of the federal government in national equity, the income tax should be an important part of its tax mix. Assignment of personal income taxes to the states runs the risk of national equity objectives being violated. States could choose different degrees of progressivity in their rate structures, at least partly driven by beggar-thy-neighbor state policies that compete away

redistribution. They could also choose much different sets of exemptions and credits as a way of favoring (or disfavoring) certain types of taxpayers, especially mobile ones.¹

Boadway and Shah suggest, however, that these problems can be avoided by allowing States to levy a surtax which piggybacks on the central income tax. This would allow the states to vary the percentage, but not the progressivity or other aspects of the tax. Taxpayers would see clearly how much tax they are paying to their State and to the Commonwealth. State voters would be able to judge whether they are getting value for money, whether they would prefer a State with lower taxes or better services. Malcolm Fraser introduced a system like this, but it was never used because Commonwealth income tax was not reduced to make room for the surtax.²

PROPERTY TAX

Another candidate for State revenue could be a broad-based tax on unimproved land values. Many State government activities are local in nature, so the benefits of spending on a particular civic facility such as a sports ground or a railway link are reflected in the wealth of those who own property in the vicinity. Property values also reflect those public goods that owners tend to avoid, such as prisons, power stations, or even heritage listings of their own property.

Property taxes are effectively a benefit tax, unlike a redistributive income tax. A lot of political jockeying for spatial advantage could be neutralized if property owners knew that any substantial change to their unimproved land values would result in either a premium or a discount on their land taxes. In other words, well designed property taxes on unimproved land values are incomparably efficient at capturing the spatial externalities of public goods.

In theory some of this externality value is captured by capital gains tax at the Commonwealth level. In reality, property investors can and do avoid capital gains tax for extended periods by reborrowing against their assets instead of selling them.³ This incentive to hold rather than sell may lead to crowding out of home buyers, as more and more dwellings are removed from the owner-occupier market to become buy-and-hold rental dwellings, depleting the pool of stock available for sale and distorting house affordability. An annual value tax like council rates avoids this distortion.

If the Commonwealth government could lower its income taxes and its grants to the States, the States could make up the difference – and abolish their own conveyancing stamp duties – using broad based land taxes. This would have to be phased in over several years, and some property owners would require a loan system similar to HECS/HELP if they were unable to pay the tax for periods of time. State stamp duties would have to be abolished to make way for the continuous land taxes, and ideally Commonwealth capital gains tax on real property would be also abolished at the outset. Local council rates could be converted into surtaxes on the State land taxes, with the States determining the structure of the tax and councils piggybacking a simple percentage on top.

¹ Robin Boadway and Anwar Shah, *Fiscal Federalism: Principles and Practices of Multiorder Governance*, Cambridge University Press, New York, 2009, p172.

² Jim Hancock and Julie Smith, *Financing the Federation*, South Australian Centre for Economic Studies, Adelaide University, 2001, retrieved from

<http://www.informatics.adelaide.edu.au/saces/publications/reports/consultancy/FinancingtheFederation.pdf>

³ Australian Treasury, *Australia's Future Tax System, Final Report*, 2010, Part 2: *Detailed analysis*, Section A1-3: *Taxation of income from savings*, retrieved from

http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_a1-3.htm

CONDITIONAL GRANTS AND HORIZONTAL FISCAL EQUALIZATION

A consequence of vertical fiscal imbalance has been a rise in the importance – and the controversy – of conditional grants to State governments, under Section 96 of the Australian Constitution.

This source of controversy could be put to rest without the need for any referendum. In what Professor Kenneth Wiltshire has described as a “sunset clause,”⁴ Section 96 was intended to have effect only for the first ten years of Federation “*and thereafter until the Parliament otherwise provides*”.⁵ The Parliament could therefore retire this power by *otherwise providing*, any time it wished to do so. Why would Commonwealth legislators ever wish to relinquish such a power? Perhaps because in a democracy governments know they are on borrowed time, and will eventually have to hand over power to others whom they consider less wise or less virtuous than themselves. The government of the day may trust itself to exercise restraint in the use of this trump-card power, but what about protecting against future abuses?

However, there is another factor to consider before condemning conditional grants, and that is Horizontal Fiscal Equalization (HFE). While there is currently no systemic relationship between HFE and S 96 conditional grants, arguably there should be.

The best use of conditional federal grants is for social welfare purposes – things like Aboriginal development and disability services, which are the concern and responsibility of all Australians regardless of which States the beneficiaries may live in. It follows that a higher proportion of conditional grants ought to go to States having a higher proportion of disadvantaged persons, and these would tend to be poorer States which have more difficulty raising their own revenue.

So there is potentially an alignment between the Commonwealth’s wish to leave no State behind, and the need for greater guidance when a State is economically underperforming. If the federation provides extra support to a particular State, it makes sense for the federation to take a particular interest in how the extra funds are allocated. Inversely, States that pull their own weight have earned the right to allocate their own spending.

But this is the opposite of what we do now. The bulk of Specific Purpose Payment (SPP) grants are distributed to the states on a per-capita basis. The Commonwealth Grants Commission then counts most of these grants along with own-source State revenue capacity, before determining how much more in GST money each State needs to take comparable care of its citizens. Furthermore, the Commission does this using a more sophisticated population count than simple per-capita, because conditions in some States require more per-capita spending than in others, to achieve comparable levels of welfare.

As a result of this, wealthier states end up receiving a higher proportion of their funding in SPP grants compared to GST grants. For poorer states it’s the reverse: the more cross-subsidy they receive, the greater proportion of their funding comes in free GST grants compared to SPP grants.

⁴ Kenneth Wiltshire, *Chariot Wheels Federalism*, Samuel Griffith Society, Volume 20, 2008. Retrieved from <http://www.samuelgriffith.org.au/papers/html/volume20/v20chap11.html>

⁵ Commonwealth of Australia Constitution Act. The entire Section 96 reads: “During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.”

It would make more sense to distribute each dollar of GST revenue back to the State in which it was collected, and then to use SPP grants to equalize between the states to some extent. This would not stop all the complaints about HFE from Western Australia, but it would at least give the Perth government more control of its budget than it has now. In fact the WA government would become the most fiscally autonomous State in the federation. The Northern Territory would become the least fiscally autonomous, forcing it to spend most of its equalization money according to Commonwealth priorities, especially for its disadvantaged Aboriginal communities.⁶

CONCLUSION

The key to reforming the Australian federation is appreciating that State electorates are the primary democratic institution for holding State governments accountable for their performance. For a variety of historical reasons, the Commonwealth government has found itself under political pressure to intervene in State issues. This has led to a dilution of State responsibility to State voters as governments increasingly seek to satisfy the Commonwealth Executive rather than their own populations. It has led to what amounts to an informal third house of federal Parliament exerting immense Executive power without democratic oversight.

As the States' house of federation, there is potentially a role for the Senate to involve itself intimately in relations between the co-sovereign elements of the Australian federation. I welcome this Inquiry and hope it will be the first step in a more permanent role.

James McDonald
20 June 2011

⁶ Due to indigenous poverty, the Commonwealth Grants Commission multiplies the NT population by approximately five to determine its adjusted per-capita need for State services. Professor Rolf Gerritson has accused the NT government of diverting the extra GST grants away from indigenous poverty and into politically influential Darwin suburbs. See for example <http://www.theaustralian.com.au/news/nt-short-changing-indigenous-aid/story-e6frg6po-111116925864>